June 27, 2003

Logistics

Allegations Concerning the Egyptian Navy Frigate Program
(D-2003-108)

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Office of the Inspector General

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Acronyms

FMF	Foreign Military Financing
NAVSEA	Naval Sea Systems Command
PMS 380	Security Assistance Program Office 380

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

June 27, 2003

MEMORANDUM FOR COMMANDER, NAVAL SEA SYSTEMS COMMAND
AUDITOR GENERAL, DEPARTMENT OF THE NAVY

SUBJECT: Report on the Allegations Concerning Egyptian Navy Frigate Program (Report No. D-2003-108)

We are providing this report for your information and use. No written response to this report was required, and none was received. Therefore, we are publishing this report in final form.

We appreciate the courtesies extended to the staff. Questions should be directed to Ms. Evelyn R. Klemstine at (703) 604-9172 (DSN 664-9172) or Mr. George Cherry at (703) 604-9614 (DSN 664-9614). See Appendix C for the report distribution. The team members are listed inside the back cover.

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Deputy Assistant Inspector General
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Office of the Inspector General of the Department of Defense

Report No. D-2003-108 **June 27, 2003**
Project No. (D2003LG-0041)

Allegations Concerning the Egyptian Navy Frigate Program

Executive Summary

Who Should Read This Report and Why? This report should be read by military assistance oversight and management personnel as well as military assistance recipients. It explains the importance of detailed performance requirements in administering Foreign Military Sales cases so that Foreign Military Financing grants are spent appropriately.

Background. Since 1989, Congress has appropriated $1.3 billion annually in nonrepayable Foreign Military Financing grants to Egypt. The Egyptian government uses those funds to procure defense articles and services through commercial contracts or the Foreign Military Sales program. Between 1994 and 1998, the Egyptian government purchased six frigates from the U.S. Government under the Foreign Military Sales program using Foreign Military Financing funds. The U.S. Navy hired a contractor to provide technical support for the transferred ships and tasked contract employees to perform additional work on the Egyptian presidential yacht in 1999. The audit was performed in response to a complaint made to the Defense Hotline. The complainant alleged mismanagement of the Foreign Military Financing funds used for the Egyptian Navy Frigate program. Specifically, the complainant alleged that funds were inappropriately spent to (1) hire retired Egyptian Navy officers, (2) rebuild personal office space, (3) pay for trips to the United States, and (4) work on the Egyptian presidential yacht. See Appendix B for a discussion of the Defense Hotline allegations and our conclusions.

Results. As stated in the allegations, we determined that Naval Sea Systems Command approved the use of Foreign Military Financing funds to hire retired Egyptian Navy officers, to rebuild office space, and for trips to the United States; however, those actions were not inappropriate. We determined that Naval Sea Systems Command also approved the use of Foreign Military Financing funds to replace sets of boiler tubes on the Egyptian presidential yacht; although questionable, we found no criteria to support that the expense was prohibited by either the law or the contract. Naval Sea Systems Command management controls have improved since the time of this action and thus appear to be adequate.

Management Comments. We provided a draft of this report on May 15, 2003. No written response to this report was required, and none was received. Therefore, we are publishing this report in final form.

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Background

Hotline Allegations. The audit was performed in response to a complaint made to the Defense Hotline that Foreign Military Financing (FMF) funds were inappropriately used on the Egyptian Navy Frigate program. See Appendix B for a complete discussion of the four allegations.

Foreign Military Financing Program. FMF is a program to carry out the provisions of Public Law 90-629, "Arms Export Control Act" (the Act), and section 23, "Credit Sales." The FMF is a program of nonrepayable grants and of repayable loans and credits to enable U.S. allies to improve their defense capabilities through the acquisition of defense articles and services. Since 1989, Congress has appropriated $1.3 billion every year in nonrepayable FMF grants to Egypt, which Egypt uses to procure defense articles and services through direct commercial contracts with U.S. contractors or through the Foreign Military Sales program. The Foreign Military Sales program includes government-to-government sales of defense articles and services from DoD stock or through new procurements under DoD-managed contracts.

Grant Agreement with Egypt. Since August 1989, the U.S. Government and the government of Egypt have annually signed a grant agreement for the use of FMF funds. The agreement allows Egypt to enter into purchase contracts with Military Departments, DoD agencies, and various U.S. commercial suppliers for the purchase of defense articles, defense services, and design and construction services of U.S. origin using FMF funds. Additionally, the agreement requires Egypt to request approval to use FMF funds for the purchase of defense items pursuant with policies defined in DoD Manual 5105.38M, "Security Assistance Management Manual." The Security Assistance Management Manual has been updated since 1989; the most current version is February 5, 2002.

Naval Organizational Structure. Under the direction of the Assistant Secretary of the Navy for Research, Development, and Acquisition, the Navy International Programs Office has oversight responsibilities for all international Navy-related programs. Naval Sea Systems Command[1] (NAVSEA) Security Assistance Program Office 380 (PMS 380) serves as the liaison between NAVSEA and the international community. PMS 380 supports more than 80 navies worldwide including more than 400 ships and their installed systems and associated weapons. PMS 380 also administers and approves how FMF funds are spent for the Egyptian Navy Frigate follow-on technical support[2] contract.

Egyptian Navy Frigate Program. From 1994 through 1998, the Egyptian government purchased two *Knox*-class and three *Perry*-class frigates[3] for a total of $165.6 million from the U.S. Government under the Foreign Military Sales

[1] NAVSEA builds, engineers, and supports U.S. Navy ships and combat systems.

[2] Follow-on technical support is the life-cycle support of every ship and shipboard system that is sold or leased to foreign governments. It includes materials, technical assistance, and sustainment of equipment and systems no longer supported by U. S. Navy infrastructure.

[3] The *Knox*-class frigates were built in the 1970s and are steam boiler powered. The *Perry*-class frigates were built in the 1980s and are diesel turbine driven.

program. Additionally, in September 1996, the U.S. Government gave one additional *Perry*-class frigate to the Egyptian government through a grant. The Egyptian Navy has used those frigates to patrol the Mediterranean Sea, protect the Suez Canal, and participate in combined exercises with the U.S. Navy. To support and maintain the six frigates, the Egyptian Navy purchased follow-on technical support. FMF funds financed five Foreign Military Sales cases.[4] In February 2003, a NAVSEA official stated that over $279 million had been disbursed for follow-on technical support provided by BAV[5] (Contractor) as well as materials, supplies, and personnel provided by the U.S. Navy under those five cases.

Follow-on Technical Support Contract. In 1995, NAVSEA awarded N00140-95-D-F021 (the Contract) to provide follow-on technical support for the former U.S. Navy ships transferred under the Foreign Military Sales program worldwide. The Egyptian Navy provides the Contractor with access to an Egyptian naval base to conduct the major overhaul and general repair work. NAVSEA writes separate delivery orders to cover requirements for each specific foreign country that receives support. As of February 2003, NAVSEA had written 39 delivery orders ($132 million) to acquire follow-on technical support for the Egyptian Navy Frigate program. NAVSEA used work orders to further define work requirements within each delivery order.

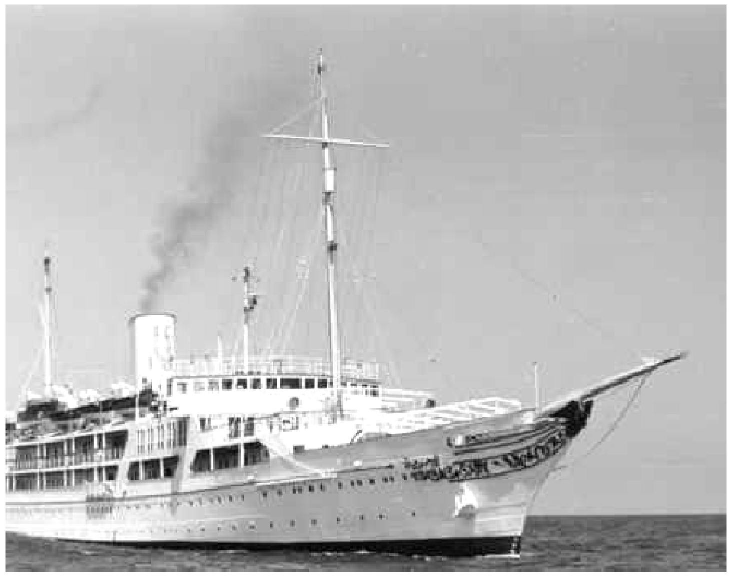
Egyptian Presidential Yacht. The Egyptian presidential yacht (Presidential Yacht) was commissioned in England in 1865 as the royal yacht for the Khedive Ismail of Egypt. In 1879, the ship ferried Khedive Ismail into exile as it would King Farouk[6] in 1952. The Presidential Yacht is officially still in service in the Egyptian Navy.

[4] A Foreign Military Sales case is an agreement between the United States and a foreign government, which lists the items or services, estimated costs, and the terms and conditions of sale.

[5] BAV is a division of VSE Corporation in partnership with Booz Allen & Hamilton Inc. to manage the Egyptian Navy Frigate follow-on technical support contract.

[6] The Khedive Ismail ruled Egypt from 1867 to 1879 and King Farouk I ruled Egypt between 1936 and 1952.

Navy officials who saw the ship identified it as a museum piece and a pleasure boat of state used mainly for Presidential parties. A recent photograph of the ship follows.



The Egyptian Presidential Yacht

Objectives

Our objective was to determine the validity of the allegations of improprieties in the use of FMF funds. Specifically, we reviewed the Egyptian Navy Frigate program to determine whether FMF funds were properly used as they relate to the allegations. We also reviewed the management control program as it relates to the overall audit objective. Refer to Appendix A for a discussion of the scope and methodology and prior coverage related to the objectives.

Egyptian Navy Frigate Program Costs

In 1999, NAVSEA authorized the use of at least $645,480 in FMF funds to replace sets of boiler tubes on the Egyptian presidential yacht. NAVSEA justified that expense as an opportunity to provide on-the-job training to three Egyptian workers. While those actions appear to fall outside the overall intent of FMF and the Contract, they were not directly prohibited. Since completing work on the Egyptian presidential yacht, NAVSEA has tightened program controls that should lessen the probability of incurring similar charges for work of a questionable nature.

Egyptian Presidential Yacht

In 1999, NAVSEA authorized the use of at least $645,480 in FMF funds to replace boiler tubes on the Presidential Yacht. NAVSEA justified the expense as an opportunity to provide on-the-job training to three Egyptian workers.

Identified Costs. Table 1 shows the identified costs associated with replacing the sets of boiler tubes on the Presidential Yacht and related costs, between March 1999 and December 1999. That amount may be understated because NAVSEA included the work on the Presidential Yacht with other non-specific expenses. Work descriptions were often ambiguous, and additional work may have been completed outside our review period.

Table 1. Egyptian Presidential Yacht Identified Costs
(March through December 1999)

Description	Identified Costs
Cleaning/ Prep work for the Presidential Yacht	$5,183
Material and Transportation	248,541
Direct Labor	353,558
Subtotal	**607,282**
General Administrative Rate* (6.29 percent)	38,198
Total	**$645,480**

*The general administrative rate is charged by the prime Contractor for managing the contract.

Work Performed. From March through December 1999, the Contractor used $645,480 to provide services and materials to replace five sets of boiler tubes on the Presidential Yacht. In April 1999 and May 1999, after the Contractor inspected the Presidential Yacht, Contractor personnel removed asbestos and cleaned the fireroom. Also in May 1999, the Contractor shipped insulation and brick to Egypt from the United States. In August 1999, the Contractor also shipped five sets of boiler tubes from the United States to Egypt. Six Contractor boiler technicians worked on the Presidential Yacht and charged over 8,100 hours between May 1999 and December 1999. A Contractor representative and a NAVSEA official stated that PMS 380 personnel orally directed the Contractor to repair the Presidential Yacht; therefore, the Contractor charged all time and materials spent for training directly to delivery order 229[7] for overhaul work.

On the Job Training. A NAVSEA PMS 380 official identified three Egyptian personnel that received on-the-job welder training provided by the six Contractor boiler technicians working on the Presidential Yacht. NAVSEA PMS 380 officials approved this work and justified the work as on-the-job training. The official stated that the Egyptian and Contractor personnel used their time effectively for training. PMS 380 personnel stated that using the Presidential Yacht as an alternative training site provided benefits to both the trained personnel and Egyptian-U.S. relationships. A PMS 380 representative further explained that the Presidential Yacht was a good training site because the size of the boiler is more suitable for training than the larger frigate boilers. Furthermore, he stated that the former U.S. frigates were unavailable for use as a training site within the needed timeframe. However, PMS 380 officials could not provide documentation that training was required or completed or that the U.S. frigates were unavailable for boiler work because those records were maintained by the Egyptian Navy.

Military Assistance

While work on the Presidential Yacht appears to fall outside the overall intent of FMF and the Contract, those actions are not directly prohibited.

Use of Foreign Military Financing Funds. The Act authorizes the use of FMF funds by specified foreign countries, and Egypt is an eligible FMF grant recipient. The purpose of the Act is to procure U.S. defense articles or defense services to foster effective and mutually beneficial defense relationships. The Act further states, "Defense articles and defense services shall be sold or leased . . . solely for internal security, for legitimate self-defense." Training and related support to military and civilian defense personnel of a friendly country is included as a legitimate defense service in the Act. Training includes:

> [F]ormal or informal instruction of foreign students in the United States or overseas by officers or employees of the United States, contract technicians, or contractors (including instruction at civilian

[7] PMS 380 uses delivery orders to document commitments between the contractor and the Government and to obligate funds to cover the Government cost and allow the contractor to get paid.

> institutions), or by correspondence courses, technical, educational, or information publications and media of all kinds, training aid, orientation, training exercise, and military advice to foreign military units and forces.

Contract. The Contract specifically provides support for:

> [F]oreign recipients of U.S. ships bought, leased or otherwise transferred through FMS [Foreign Military Sales] program, the means to economically support these ships for the remainder of their Life Cycles by U.S. contractors. The services for this program will include design, configuration management, field engineering, maintenance planning, maintenance, spare parts support, training, casualty and depot level repairs.

The purpose of the Contract is to provide life-cycle support for former U.S. Navy ships. The Contract includes training as part of the life-cycle support for the transferred ships. Training does not have to be performed solely on former U.S. ships. For example, to support the Egyptian frigates, training is regularly conducted in a classroom setting. Classroom training typically has clear objectives and is an effective way to train several personnel at one time.

According to a PMS 380 official, the Presidential Yacht was used as an alternative training site for three Egyptian personnel who will provide life-cycle support for the former U.S. frigates. In our opinion, this broadens the scope of the Contract beyond what was intended; however, neither the Act nor the Contract directly prohibits this type of work.

Delivery Order 229. The Contractor charged delivery order 229 to fund the repairs on the Presidential Yacht; however, the delivery order did not specifically task the Contractor to perform the repairs. The statement of work in the delivery order directed the Contractor to perform only general repair and support duties. Delivery order 229 states that:

> Services to be provided under this delivery order shall consist of actions necessary to repair, maintain, overhaul, and install shipboard systems and equipment; industrial and logistics upgrade services; training; and equipment procurement services for material and repair parts.

Work Order. Similar to the delivery orders, the work orders[8] that were used to fund the repairs to the Presidential Yacht provided only vague work descriptions and the estimated work hours. For example, one typical work order states:

> The contractor shall provide a boiler repair team consisting of sixteen (16) permanent men to overhaul boilers.

[8] PMS 380 uses work orders to document specific requirements or evolving commitments of the delivery order.

As a consequence, almost any job completed with FMF funds or under the Contract could have been classified as "training."

Tightened Program Controls

NAVSEA has subsequently tightened program controls, which should help lessen the probability of similar charges for work of a questionable nature.

Program History. In the early years of the contract, NAVSEA made on-site Contractor personnel available to accommodate the requirements of the Egyptian customer. NAVSEA personnel stated that the Contract scope was intentionally written in broad terms to accommodate the various requirements. At the time, support operations were in transition from a predominantly Russian-developed naval facility to one that would support U.S. built ships.

Improved Controls. NAVSEA personnel stated that as the Egyptian Navy Frigate program matured, NAVSEA and Egyptian Navy representatives increased management control over the program through additional periodic on-site visits and more specific work requirements for the Contractor. In December 2000, to improve oversight, NAVSEA and the Contractor increased the number and frequency of on-site visits from once a year to about five times per year. The site visits increased management awareness of current operations and future projects. Also in December 2000, NAVSEA and the Egyptian Navy changed their procedures in order to more fully document specific requirements for the Contractor through the use of work packages. As a result of those on-site visits, Egyptian Navy personnel, with technical input from the Contractor and NAVSEA approval, developed detailed work packages for work to be performed by the Contractor. Work packages define work requirements in very specific terms, for a specific time period, and include a delivery schedule and list of personnel and material requirements. For example, a work package for a ship overhaul may contain specific references to part numbers (vent fan motor 1-129-1); items to repair (repair No. 3 and No. 4 fire pump motors); and locations (replace feed water valves on No. 2 distilling plant). Formerly, the delivery order and work orders would include very broad and non-specific work requirements.

Achievements. NAVSEA has taken actions to define performance requirements in delivery orders for the Egyptian Navy Frigate program. We reviewed the statements of work on 39 delivery orders supporting work on the Egyptian Navy Frigate Program. Of the 32 delivery orders signed prior to December 2000, 14 contained vague work descriptions and identified the work requirement in estimated work hours. However, after December 2000, all seven delivery orders adequately described the Contractor duties in the statement of work, and four of those seven delivery orders required the Contractor to perform in accordance with approved work packages. Those work packages provided significantly more detailed work descriptions than the earlier delivery orders.

Conclusion

The work performed on the Presidential Yacht appears questionable. The Presidential Yacht is a historical ship that is not likely to be used for a legitimate defensive purpose nor to enhance Egyptian internal security. However, we could find no legal or contractual impediment to the use of FMF funds for repairs made on the Presidential Yacht, particularly because NAVSEA classified it as an alternative training site. NAVSEA has changed procedures since completing work on the Presidential Yacht, which should reduce the likelihood of similar questionable charges. Therefore, we are not making any recommendations.

Appendix A. Scope and Methodology

We performed this audit from December 2002 through April 2003 in accordance with generally accepted government auditing standards. Our scope was limited because we did not travel to the work site and were unable to view training documentation, Egyptian Navy travel vouchers, or the actual work completed.

We reviewed DoD guidance that governs and administers security assistance. We analyzed Public Law 87–195, "The Foreign Assistance Act of 1961," September 4, 1961; Public Law 90–629, "The Arms Export Control Act," October 22, 1968; Executive Order 11958, "Administration of Arms Export Controls," January 18, 1977; DoD Manual 5105.38, "Security Assistance Management Manual (SAMM)," February 5, 2002; DoD Directive 5010.38 "Management Control Program," August 26, 1996; DoD Instruction 5010.40, "Management Control Program Procedures," August 28, 1996; NAVSEA Instruction 5200.13B, "Management Control Program," May 5, 2000; and Navy Office of Technology Transfer and Security Assistance Internal Policy Directive 89-27, "Management Control Program," December 14, 1989.

We reviewed overall policies, procedures, and documentation related to the Egyptian Navy Frigate program as supported by contract N00140-95-D-F021. We also reviewed 5 Foreign Military Sales cases and 39 associated delivery orders. Additionally, we reviewed Contractors monthly status reports covering the period January 1996 through December 2002. From the review of delivery orders and Contractor monthly status reports, we identified and reviewed questionable items in on-site expense invoices covering the periods November 1998 through November 2000 and December 2001 through September 2002. Also, we interviewed NAVSEA, Navy International Programs Office, Contractor, and subcontractor personnel.

Use of Computer Processed Data. We did not use computer-processed data to perform this audit.

General Accounting Office High-Risk Area. The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the DoD Contract Management high-risk area.

Management Control Program Review

DoD Directive 5010.38, "Management Control (MC) Program," August 26, 1996, and DoD Instruction 5010.40, "Management Control (MC) Program Procedures," August 28, 1996, require DoD organizations to implement a comprehensive system of management controls that provides reasonable assurance that programs are operating as intended and to evaluate the adequacy of the controls.

Scope of Review of the Management Control Program. We reviewed the adequacy of NAVSEA management controls over Foreign Military Sales. Specifically, we reviewed the implementation of U.S. laws and DoD policies as

they relate to the Egyptian Navy Frigate program. Because we did not identify a material weakness, we did not assess management's self-evaluation.

Adequacy of Management Controls. NAVSEA management controls were adequate; we identified no material management control weaknesses.

Prior Coverage

During the last 5 years, the General Accounting Office (GAO) and NAVSEA have issued three reports discussing Foreign Military Sales. Unrestricted GAO reports can be accessed over the Internet at http://www.gao.gov.

GAO

GAO Report No. GAO-00-208, "Foreign Military Sales: Changes Needed to Correct Weaknesses in End-Use Monitoring Program," August 24, 2000

GAO Report No. GAO-99-213, "Foreign Military Sales: Navy's Accounting for Sales to Foreign Customers Needs Improvement," August 24, 1999

NAVSEA

NAVSEA Office of Inspector General, "Management Control Program Audit of NAVSEA Foreign Military Sale Program Timekeeping Procedures," March 2002

Appendix B. Summary of Allegations

The audit was conducted in response to allegations made to the Defense Hotline. The following is a summary of the allegations not discussed in the body of the report and the specific results of each allegation.

Allegation No. 1: Foreign Military Financing funds were spent to hire retired Egyptian Navy officers.

Audit Results: We determined that Naval Sea Systems Command approved the use of FMF funds to hire retired Egyptian Navy officers. However, the practice of hiring local nationals is not improper as long as the contractor does not exceed the 50 percent foreign content threshold. The Security Assistance Management Manual, Section 90210, states that funds made available under the Arms Export Control Act can be "offshore procurement" if the costs from foreign origin are less than one-half of the dollar value of the contract or the project, after subtracting "buy American" items excluded in the Financial Acquisition Regulation and the Defense Financial Acquisition Regulation Supplement. We reviewed 12 current independent consultant agreements between the Contractor and Egyptian nationals who perform work under the Contract. Eleven of the consulting agreements were with retired Egyptian Navy personnel who performed engineering, liaison, and logistics support; the remaining consultant served as a senior engineer. The total cost for all consulting agreements, an estimated $270,000 a year, was well below the 50 percent threshold identified in the Security Assistance Management Manual. Funds were legitimately spent to hire retired Egyptian naval officers and, thus, resulted in no adverse effect.

Allegation No. 2: Foreign Military Financing funds were spent to rebuild personal office space.

Audit Results: We determined that Naval Sea Systems Command approved the use of FMF funds to rebuild office space. However, work performed was within the scope of FMF requirements. To identify expenditures potentially related to construction of personal office space, we reviewed 39 delivery orders (January 1995 through January 2003) and Contractor's monthly status reports (January 1996 through December 2002) for the follow-on technical support program. This lead to a review of all of the on-site expense invoices from November 1998 through November 2000 and December 2001 through September 2002. The expenses we identified were modest in nature and appeared legitimate. For example, the Contractor purchased an office trailer, which included furniture and an air conditioning unit, for $6,879; lighting fixtures for office space for $27; and a toilet seat for $15. Additionally, the Contractor remodeled an Egyptian "villa" to serve as office space to support administrative requirements. We were unable to identify the cost of remodeling because NAVSEA and Contractor personnel could not recall when the remodeling took place but stated that the costs, which mainly consisted of office furniture, were not substantial in nature. NAVSEA and Contractor personnel explained that the villa, or Egyptian office building, is vital to the Contractor's administrative and planning duties because access to the Egyptian naval facility was limited to specific hours of operation.

Funds spent on rebuilding or remodeling office space were modest and generated no adverse effects.

Allegation No. 3: Foreign Military Financing funds were used to pay for Egyptians to travel to the United States.

Audit Results: We determined that Naval Sea Systems Command approved the use of FMF funds for trips to the United States. However, we could only identify funds spent to reimburse Egyptians traveling to the United States for training. The Foreign Assistance Act, part II, chapter 5, specifically authorizes "attendance at military educational and training facilities in the United States" to be within the scope of FMF requirements. The documentation revealed that Egyptians traveled to the United States with FMF funds for training purposes. We also identified 35 Egyptian personnel who visited the United States from 1996 through 2002 to attend program management reviews on the Egyptian Navy Frigate program. The travel for Egyptian personnel attending program management reviews cannot be reimbursed with FMF funds. To identify if the 35 Egyptian personnel used FMF funds to attend the program management reviews, we reviewed the following:

- Contractor travel records for charges claimed in 1999, 2000, and 2002;
- Foreign Military Sales case files associated with follow-on technical support for the Egyptian frigates; and
- Defense Finance and Accounting Service travel disbursement records related to the Foreign Military Sales cases.

We found no evidence that U.S. Government funds were used to reimburse the travel expenses associated with those program management reviews.

Allegation No. 4. Foreign Military Financing funds were used to pay for repairs to the Presidential Yacht.

Audit Results: We determined that Naval Sea Systems Command approved the use of at least $645,480 in FMF funds for work on the Presidential Yacht. The work on the Presidential Yacht appears to fall outside the intent of FMF grant funds; however, the work was not directly prohibited when classified as on-the-job training costs. See the Finding section for a discussion of the allegation.

Appendix C. Report Distribution

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